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Income Tax Rulings Directorate
Legislative Policy and Regulatory Affairs Branch
Canada Revenue Agency
Ottawa ON K1A 0L5

The *Income Tax Technical News* can be found on the Canada Revenue Agency Internet site at **www.cra.gc.ca**.

This issue contains topics of current interest that were discussed at the annual **Canadian Tax Foundation** conference held in Calgary from November 30 to December 2, 2008. Members of the panel were Mr. Wayne Adams, Director General, Income Tax Rulings Directorate, Mr. Daryl Boychuk, Manager of the International Section I of the Income Tax Rulings Directorate, and Mr. Peter Dunn, Manager of the GARR and Technical Support Section, Aggressive Tax Planning Division of the International and Large Business Directorate, all three with the Canada Revenue Agency, and Mr. Doug Ewens of McCarthy, Tétrault LLP, Calgary and Mr. Trent Henry of Ernst & Young LLP, Toronto.

Unless otherwise stated, all statutory references throughout this Income Tax Technical News *are to the* Income Tax Act *(the "*Act*").*

Eligible Dividend Designation – Subsection 89(14)

A taxable dividend, including a deemed dividend received by a resident of Canada after 2005, is an eligible dividend only if the corporation designates it as an eligible dividend. To designate a taxable dividend as an eligible dividend, the corporation must notify in writing the person to whom it pays the dividend that all or any part of the dividend is an eligible dividend.

Question 1

How is the designation rule to be applied where the registered holder of a share is a mere nominee for the owner of the share (for example, in a book-based system)? It seems that a notice to the registered holder of the share would be sufficient to comply with the technical wording of the rule, but there has been no obligation on the nominee to advise the beneficial owner of the share that the dividend is an eligible dividend, which would seem to frustrate the purpose of the rule. Can the Canada Revenue Agency (CRA) please comment on this point?

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Canada

Response 1

Subsection 89(14) of the *Income Tax Act*[1] provides that a corporation designates a dividend to be an eligible dividend

> "by notifying in writing at [the time it pays a dividend] each person or partnership to whom it pays all or any part of the dividend that the dividend is an eligible dividend."

Generally, corporate law requires that a corporation maintain a securities register wherein it records the name and last known address of each holder of its securities[2]). Where a corporation pays a dividend on a particular share, it is generally entitled to treat the registered owner of the share as the person exclusively entitled to receive the dividend[3]).

Subject to acceptable alternatives described in our general guidelines referred to below, a corporation that seeks to designate a dividend to be an eligible dividend will be required to give written notification to each person to whom it pays any part of the dividend by giving such written notification to the registered owner of the share on which the dividend is paid at the owner's address in the corporation's securities register.

In most cases where a book-entry system is maintained to record the beneficial owner of shares of a particular corporation, that corporation's shares will be publicly traded and the corporation will be entitled to rely on the procedure for designating an eligible dividend that was described in our general guidelines released on December 20, 2006, *Designation of Eligible Dividends*[4]. For public companies, we stated, in part:

> "Acceptable methods of making a designation are posting a notice on the corporation's website, and in corporate quarterly or annual reports or shareholder publications. We will consider that a notice posted on a corporate website is notification that an eligible dividend is paid to shareholders until the notice is removed. Similarly, a notice in an annual or quarterly report that an eligible dividend has been paid is considered valid for that year or quarter, respectively. Alternatively, if a public corporation issues a press release announcing the declaration of a dividend, a statement in the press release indicating that the dividend is an eligible dividend will be sufficient proof that notification was given to each shareholder."

Reference should be made to the guidelines for additional comments concerning eligible dividend designations. See also Response 5 below.

Question 2

As a technical matter, it appears that the current provisions of the Act do not permit an eligible dividend received by a Canadian resident trust and distributed to a Canadian beneficiary to retain its character as an eligible dividend in the hands of the beneficiary. If this is not an intended result, how does the CRA plan to deal with this issue?

Response 2

It is our view that a taxable dividend, designated as an eligible dividend under subsection 89(14), that is paid to a Canadian resident trust will maintain its character when distributed by that trust to its Canadian resident beneficiaries under subsection 104(19). In order for a taxable dividend to qualify as an eligible dividend, it must meet the criteria in the eligible dividend definition in subsection 89(1). Under subsection 89(1), the taxable dividend must be received by a person resident in Canada, be paid after 2005 by a corporation resident in Canada, and be designated as an eligible dividend in accordance with subsection 89(14). Subsection 104(19) states that, under certain conditions, a taxable dividend received by a trust resident in Canada is deemed to be a taxable dividend received by the beneficiary of the trust from the corporation paying the dividend. Provided the conditions in the definition of eligible dividend, as outlined above, are met, the taxable dividend received by the Canadian beneficiary would qualify as an eligible dividend.

Question 3

What is the CRA's position with regard to a corporation reorganizing its share capital into two classes, one for non-residents on which eligible dividends would not be paid, and the other for residents on which eligible dividends would be paid?

Response 3

Eligible dividends paid to individuals resident in Canada are subject to a lower effective rate of tax as a result of an enhanced dividend "gross-up" and enhanced dividend tax credit. Shareholders that are not resident in Canada are not entitled to the enhanced dividend "gross-up" and enhanced dividend tax credit.

In order to pay an amount as an eligible dividend, the corporation paying the dividend must designate the full amount of the dividend as eligible dividend. Partial designations are not possible.

Questions have been raised about the effect on a Canadian-controlled private corporation's (CCPC)

general rate income pool (GRIP) when a portion of the amount that it designates as an eligible dividend is received by a person that is not resident in Canada. There is concern that by designating the full amount of a dividend to be an eligible dividend, the CCPC will be required to reduce its GRIP by the full amount of the dividend, notwithstanding that at least a portion of the amount of the dividend was received by a shareholder that is not resident in Canada and therefore not entitled to the benefit of the enhanced dividend "gross-up" and enhanced dividend tax credit.

At question 6 of the CRA Round Table discussion at the recent 2008 *Congrès de l'Association de planification fiscale et financière* (the 2008 APFF conference),[5] the CRA confirmed that, in order for an amount to be an eligible dividend for purposes of the Act, all of the essential conditions set out in the definition of "eligible dividend" in subsection 89(1) must be satisfied. One of the essential conditions is that the full amount of the dividend must be designated as eligible dividend. Another essential condition is that the amount must be received by a person that is resident in Canada. Where the full amount of a dividend is designated as an eligible dividend, but a portion of the dividend is received by a person that is not resident in Canada, the portion received by the non-resident will not meet all of the essential conditions and will not be an eligible dividend for purposes of subparagraph (a)(i) of component "I" of the formula for the calculation of the dividend payor's GRIP. In other words, the portion of the dividend received by the non-resident will not reduce the CCPC's GRIP. As a result, CRA considers the reorganization described above to be unnecessary in order for a CCPC to maximize the benefit of its GRIP to its Canadian-resident shareholders.

Question 4

In 2006, the CRA allowed handwritten notification for the payment of eligible dividends on T3 and T5 slips. The CRA indicated at the 2006 Canadian Tax Foundation Annual Conference CRA Round Table that it would consider whether this practice should be extended to subsequent taxation years.[6] Will the CRA consider handwritten notification on T3 and T5 slips sufficient notification for the payment of eligible dividends for the 2008 and subsequent years?

Response 4

Our position at the 2006 annual conference was taken in view of the fact that, at the time of our comments, the eligible dividend legislation had not yet received Royal Assent. As a result, the coming-into-force provisions, which provided that notification by May 22, 2007 for any dividends paid before February 21, 2007 would comply with subsection 89(14), were not yet published. Our comments were made, and the coming-into-force provisions were adopted, to deal with cases where corporations had paid eligible dividends prior to the legislation receiving Royal Assent. The CRA confirmed that it is important that recipients of dividends receive timely notification of eligible dividends, particularly when a corporate shareholder passes those dividends on to its own shareholders. The CRA confirmed that dividends would not be considered ineligible solely due to the timeliness and/or method of notification until the end of the 2008 calendar year. Corporations will need to take the necessary steps to implement proper and timely notification protocols for 2009 and subsequent taxation years.

Question 5

Read literally, subsection 89(14) requires the shareholder to be notified at exactly the same moment that the dividend is paid. Is that how the CRA interprets that subsection? If not, can the notice be before or after the payment and, if so, by how much long before or after?

Response 5

Generally, notification at or before the time the dividend is paid is appropriate notification for the purpose of subsection 89(14) as set out in our general guidelines:

> "**For 2007 and Subsequent Taxation Years Public Corporations**
>
> For 2007 and subsequent taxation years, for public corporations, we will accept that notification has been made if, before or at the time the dividends are paid, a designation is made stating that all dividends are eligible dividends unless indicated otherwise. Acceptable methods of making a designation are posting a notice on the corporation's website, and in corporate quarterly or annual reports or shareholder publications. We will consider that a notice posted on a corporate website is notification that an eligible dividend is paid to shareholders until the notice is removed. Similarly, a notice in an annual or quarterly report that an eligible dividend has been paid is considered valid for that year or quarter, respectively. Alternatively, if a public corporation issues a press release announcing the declaration of a dividend, a statement in the press release indicating that the dividend is an eligible dividend will be sufficient proof that notification was given to each shareholder.

All Other Corporations

For 2007 and subsequent taxation years, for all corporations other than public corporations, the notification requirements of proposed subsection 89(14) must be met each time a dividend is paid. Examples of notification could include identifying eligible dividends through letters to shareholders and dividend cheque stubs, or where all shareholders are Directors of a corporation, a notation in the Minutes."

The "More Than Five Full-Time Employees" Test

In *489599 B.C. Ltd. v. The Queen*,[7] a CCPC had five full-time employees and two part-time employees. The issue was whether the CCPC employed "more than five full-time employees" for the purposes of the definition of "personal services business" set forth in subsection 125(7). The Tax Court of Canada concluded that the CCPC did have more than five full-time employees, that is, that the provision did not require it to employ at least six full-time individuals, as indicated in paragraph 15 of IT-73R6.[8]

Question

Does the CRA agree with the interpretation given by the Tax Court of Canada in the *489599 B.C. Ltd.* case?

Response

The CRA accepts the decision in *489599 B.C. Ltd.* that, in determining whether a corporation is carrying on a "personal services business" as defined in subsection 125(7), the requirement in paragraph (c) of the definition that the corporation employs "more than five-full time employees" is met when a corporation has five full-time employees plus one or more part-time employees. This interpretation is also applicable to determining whether or not the "more than five full-time employees" requirement in the definition of "specified investment business" is satisfied. This supersedes the position set out in paragraph 15 of IT-73R6.

Meaning of "Business"

The Supreme Court of Canada's (SCC) definition of "business" seems much broader than the "system of risk minimization" test employed by the Tax Court of Canada in *Leblanc et al. v. The Queen*,[9] (that is, the SCC held in *Stewart v. The Queen*,[10] that there is no single factor that determines whether a taxpayer has a business, but in *Leblanc*, the Tax Court of Canada (TCC) reduced the test to one factor). Consequently, the *Leblanc* decision raises questions about the proper test for determining whether there is a business, which is applicable to both gambling and non-gambling cases.

Question

Can the CRA provide its position on this matter?

Response

Assessing the taxability of gambling activities is unique in a number of ways. Games of pure chance, like lotteries, lack the badges of trade to which the traditional tests of business activity can be applied. Traditional tests to determine the existence of a "business" include an assessment of a taxpayer's profit-making purpose (that is, "pursuit of profit") and the commerciality of a taxpayer's activity.

Gambling is always undertaken in "pursuit of profit." This was addressed in *Balanko v. M.N.R.*, where the court stated that gambling with a view to profit is an intention

> "shared by all who gamble, and the presence of the intention to win or make money in gambling, which is there in all who gamble, does not lead to a conclusion that all who gamble, or even all those who gamble frequently, are carrying on a business."[11]

Usually the frequency and systematic nature of an activity would be indicative of a "business." The traditional common-law definition of business is "anything which occupies the time and attention and labour of a man for the purpose of profit"[12]

> "Such a definition would usually be unexceptionable when one is talking about a commercial activity. If applied literally and mechanically it would include the activities of a person who consistently and regularly placed bets on horses, or played the lotteries or the gaming tables. It would mean that the gambling activities in every case that I have cited would be a business, yet we know that this is not so. Gambling-even regular, frequent and systematic gambling-is something that by its nature is not generally regarded as a commercial activity except under very exceptional circumstances."[13]

There are some exceptional cases, which are noted in *Leblanc*, where gambling activities have been held to be taxable; however, these relate to taxpayers who applied inside information, knowledge and skill to their activities (for example, in *Luprypa v. The Queen*,[14] a pool player who in cold sobriety would challenge inebriated pool players to a game of pool was held to be

taxable on his winnings) and can therefore be clearly distinguished from the facts in *Leblanc*.

The *Stewart* case recommended applying a two-stage test to determine whether a source of income exists. The first-stage test asks: "Is the activity of the taxpayer undertaken in pursuit of profit, or is it a personal endeavor?" The second-stage test asks: "If it is not a personal endeavor, is the source of income a business or property?" Under the first-stage test, where a taxpayer's undertaking could be considered a hobby or other personal activity but it is carried out in accordance with objective standards of businesslike behaviour, it will still be considered a "source of income."

While the "pursuit of profit" test is meaningful in other cases, it is not a meaningful test to apply to a gambling activity. Gambling is anomalous because no one gambles for any reason other than in a pursuit of profit. Accordingly, when the first-stage test is applied to gambling cases, one would always conclude that the "pursuit of profit" element was satisfied. Furthermore, the usual indicia of commerciality, such as frequency and systemization, are also not relevant criteria to be applied to a game of chance.

If the TCC in *Leblanc* had specifically referred to *Stewart* and stated that it was applying the first-stage test, it likely would have determined that there was a pursuit of profit and a personal element involved (that is, the taxpayers were considered to be compulsive gamblers). It would have then determined whether the personal activity or hobby was undertaken in accordance with objective standards of businesslike behaviour in which the TCC would have considered the management of risk as the appropriate objective test to apply. On this assessment, the TCC would have again concluded that there was no "source of income."

Accordingly, in our view, the "source of income" test and principles adopted by the TCC in *Leblanc* are not inconsistent with those applied by the SCC in *Stewart*. They simply reflect the uniqueness of gambling activities.

Rulings (Opinions) on Proposed Legislative Amendments

Question

What is the CRA's practice on re-assessing a taxpayer contrary to an opinion given by the Rulings Directorate based on proposed rules that have not been enacted into law as part of the Act?

Response

The CRA will provide an opinion on proposed legislation, and the CRA permits a taxpayer to file a return based on proposed legislation. However, if a particular return may go statute-barred and the legislation is not yet passed, the CRA will request a waiver or assess based on the actual legislation if the waiver is refused.

Definition of "Tax Shelter" – Subsection 237.1(1)

Briefly, in *Maege v. The Queen*,[15] the Federal Court of Appeal considered whether a tax shelter existed despite the absence of statements or representations directly made to a taxpayer. The Court affirmed the reasoning of the Tax Court of Canada in concluding that a tax shelter could exist in the absence of statements or representations made directly to the taxpayer. Notwithstanding a plain reading of the definition of "tax shelter" in subsection 237.1(1), the Tax Court seems to suggest that statements or representations may not be an essential element of a tax shelter (that is, in *obiter*, Rip J. (as he then was) rejected the argument that the phrase "statements or representations" is an essential element of the definition, noting that it is preceded by the words "having regard to").[16] This issue has also been addressed in *Baxter v. The Queen*.[17]

Question

In light of the *Maege* decision, what is the CRA's position regarding the significance of statements or representations made in the context of the definition of a tax shelter?

Response

In our view, the decisions in *Maege* and *Baxter* are consistent with our position that statements or representations do not have to be made to a particular investor in order for a particular investment to be considered a tax shelter. Paragraph (*b*) of the definition of "tax shelter" in subsection 237.1(1) of the Act reads as follows:

> "(*b*) a gifting arrangement described by paragraph (*a*) of the definition "gifting arrangement", or a property (including any right to income) other than a flow-through share or a prescribed property, in respect of which it can reasonably be considered, **having regard to statements or representations made or proposed to be made** in connection with the gifting arrangement or the property, that, if a person were to enter into the gifting arrangement or

acquire an interest in the property, at the end of a particular taxation year that ends within four years after the day on which the gifting arrangement is entered into or the interest is acquired, ..." [emphasis added]

The test in the definition of a "tax shelter" in section 237.1 is whether statements or representations have been made or proposed to be made in connection with the property. On this basis, once a property meets the definition of a tax shelter it becomes a tax shelter for all owners. Further, as Evans J clarified in *Baxter*, there may be circumstances in which property can be found to be a tax shelter on the basis of statements or representations that a promoter proposes to make.

In *Maege*, the Tax Court of Canada found that the absence of statements or explicit representations was not determinative in deciding the issue of whether a tax shelter exists. These comments were made in addressing the testimony given by the promoter concerning this point. The question was resolved by reference to the investment sophistication of the taxpayers and, consequently, the likelihood that they knew a tax shelter existed. It is important to note that the Tax Court justified this position by emphasizing that the definition of "tax shelter" in section 237.1 did not refer to "explicit representations" and that the term "representation" can be interpreted broadly. Accordingly, it is our view that the *Maege* decisions at the Tax Court and the Federal Court of Appeal do not represent a departure from the requirement that statements or representations be made or are proposed to be made in connection with a property when applying the tax shelter rules; rather they adopt a broad view of this requirement, especially when sophisticated investors are involved.

Donation of Flow-Through Shares – subparagraph 38(*a*.1)(i), subsection 248(35) through (41) and section 237.1

Because of the flow-through nature of the deductions available to a subscriber of a flow-through share, the deemed cost of such shares to the subscriber is nil. With the elimination of capital gains taxes on shares of a public corporation donated to registered charities, the donation of flow-through shares issued by public corporations is an effective way to avoid paying such capital gains taxes that could be very significant on the disposition of flow-through shares. If such flow-through shares are acquired for the sole purpose of gifting them to a registered charity, then the donation of flow-through shares may be an arrangement that technically qualifies as a tax shelter. If a tax shelter is not registered under the Act, then the deductions with respect to that tax shelter may be disallowed.

Question

Since both the flow-through share rules and the rules to eliminate taxable capital gains from charitable donations of shares of public corporations are incentives aimed at encouraging such subscriptions and donations, what is the CRA's position with regard to whether such donations will be classified as a tax shelter (and subject to the tax shelter registration rules)?

Response

The definition of "tax shelter" in subsection 237.1(1) of the Act includes a "gifting arrangement" which as defined in that subsection means any arrangement under which it may reasonably be considered, having regard to statements or representations made in connection with the arrangement, that if a person were to enter into the arrangement, the person would make a gift to a qualified donee. The exclusion of a flow-through share in paragraph (*b*) of the definition of "tax shelter" is in reference to the acquisition of a property that is a flow-through share that has not been acquired pursuant to a "gifting arrangement" described in paragraph (*b*) of that definition.

The purpose of the tax shelter registration rules is to identify the arrangements that fall within the definition of "tax shelter" for review by the CRA. The issuance of an identification number by the CRA is not to be construed as the CRA approving the arrangement. On the other hand, it also does not mean that a subsequent audit will result in adjustments.

The CRA has already issued identification numbers in respect of several flow-through share/donation arrangements and has in fact issued advance income tax rulings on some arrangements. Nevertheless the requirement to obtain a registration identification number allows us to review all such arrangements for compliance with the provisions of the Act.

Date-Stamping Procedures

On or about October 3, 2006, the CRA closed its public mail counters and discontinued the date stamping service. On or about December 7, 2006, during an appearance before a meeting of the House of Commons Standing Committee on Finance, the Minister of National Revenue announced that the CRA would provide a uniform, on-demand date-stamping service for hand delivered correspondence in every local office across Canada. This service is to consist of the CRA

counter staff placing a date-of-delivery stamp on sealed envelopes received at local office counters for deposit into drop boxes, thereby creating a record of the transaction. Since this announcement, these date-stamping procedures have been anything but "uniform" in practice and many practitioners are both concerned about and frustrated by the CRA's inconsistency in respect of these procedures.

Question

Can the CRA provide an update on how it intends to implement this uniform national standard for date-stamping deliveries and the timeline for implementation of the standard across Canada?

Response

In recognition of the value that taxpayers and tax practitioners place on date stamping, the CRA implemented a uniform stamping-on-demand service in all local offices on December 11, 2006. The service includes the stamping on demand of original documents, envelopes, lists, or photocopies provided by the taxpayer. The service does not include the verification or examination of the content of the documents being stamped.

This new policy was communicated to every Tax Services Office (TSO) and the procedure guide was updated. Every TSO is currently following the procedure to ensure consistency across Canada.

Currently, date stamping is done manually by the Taxpayer Services and Debt Management Branch employees. The employee places a stamp, if requested by the taxpayer, on the envelope, return, photocopy or list received from the taxpayer. The CRA staff do not open or verify any of the contents or documents received. If taxpayers want a stamped copy returned as proof of delivery, they must provide a photocopy of the document with the original.

Conversion from Canadian GAAP to IFRS

On February 13, 2008, the Canadian Accounting Standards Board stated that all publicly accountable entities (PAEs) are required to adopt the international financial reporting standards (IFRS) in respect of financial years starting on or after January 1, 2011.[18] The impact of various accounting policy changes may significantly alter the balance sheet and the determination of accounting income in comparison with current Canadian generally accepted accounting principles (GAAP). For example, taxpayers may incur expenditures that were expensed in a prior period in determining book income of the taxpayer under Canadian GAAP but that are required to be capitalized on the balance sheet on conversion to IFRS (and therefore expensed again in book income in a future period under IFRS), or alternatively, they may incur expenditures that were capitalized on the balance sheet for book purposes under Canadian GAAP but which may require a prior period adjustment to retained earnings on conversion to IFRS, (and therefore may never be expensed in book income). Additionally, there may be differences in the timing of recognition of income between Canadian GAAP and IFRS and, therefore on conversion, there may be items of income that will never be recognized in book income due to conversion from Canadian GAAP to IFRS or, conversely, items that are recognized more than once in book income due to conversion from Canadian GAAP to IFRS. The following questions are related to the impending implementation of IFRS.

Question 1

Will the CRA be issuing guidance to taxpayers who are adopting IFRS in determining taxable income, and in particular guidance dealing with changes from current standards to IFRS?

Response 1

Yes. We are currently evaluating these significant changes to accounting principles and their potential impact on the administration of the Act. A communication strategy is being developed to ensure that guidance is provided to all stakeholders.

Given the extent of the statutory rules that override accounting treatment, we expect that taxable income will not be significantly affected by the change; however, the computation of taxable income could be much more complex. We expect to issue an *Income Tax Technical News* during 2009 outlining our views on the impact of the conversion to IFRS.

Question 2

Is the CRA considering implementing a process through which taxpayers may proactively raise issues expected to be encountered in the process of conversion to IFRS, so as to reduce uncertainty to their current and future tax liability position caused by the adoption of IFRS?

Response 2

Yes. The Income Tax Rulings Directorate is available to receive specific queries regarding how the interpretation of Canada's income tax law, (including the Act, the *Income Tax Regulations*, all related statutes and

Canada's income tax conventions with other countries) is affected by any particular IFRS or international accounting standard. We encourage you to submit your queries to IFRS@cra-arc.gc.ca. As new issues are identified, we will update our guidance on the ITTN.

Also, as part of our evaluation process, we are developing a communication strategy to incorporate a means of ensuring cross-communication between stakeholders and the CRA. In addition to questions of calculation, we expect to work with you to develop revisions to our general index of financial information forms, and lists of adjustments you should consider on schedule 1 of a T2 return.

Question 3

Many taxpayers are already required to complete books and records based on IFRS as well as under Canadian GAAP (for example, Canadian-resident subsidiaries of parent companies, where the parent is required to prepare consolidated financial statements using IFRS). Does the CRA currently consider IFRS-compliant financial statements acceptable to file with a taxpayer's tax return?

Response 3

Yes. The Act does not specify that financial statements must be prepared following any particular type of accounting principle or standard. As the Supreme Court of Canada stated in *Canderel Ltd. v. Canada*,[19] the determination of profit is a question of law. Accounting standards are not law. In seeking to ascertain profit, the goal is to obtain an accurate picture of the taxpayer's profit for purposes of section 3 of the Act for the given year. The Supreme Court stated that a taxpayer is free to adopt any method that is not inconsistent with:

(a) the provisions of the Act;

(b) established case law principles; and

(c) well-accepted business principles.

It is our view that financial statements based on IFRS would be an acceptable starting point to determine income for tax purposes. In addition, where IFRS are used by a particular entity, it is our position that references to GAAP in the Act can be read as references to IFRS, and all references to GAAP in any CRA publication can also be read as references to IFRS for those entities that report under IFRS.

Question 4

Will the CRA be working with the provinces to develop a harmonized approach in assessing taxable income in respect of adopters of IFRS?

Response 4

We have identified the provinces as key stakeholders in the transition process to IFRS. Accordingly, our communication plan will include the provinces in order to ensure that all issues are identified and resolved.

Exchangeable Debentures – Paragraph 20(1)(*f*)

In *Imperial Oil Ltd. v. Canada*,[20] the Supreme Court of Canada held that paragraph 20(1)(*f*) does not apply to foreign currency losses. The CRA stated verbally at the 2006 Canadian Tax Foundation Annual Conference that commodity-based loans and exchangeable debenture financings currently in place would still be eligible for paragraph 20(1)(*f*) treatment. The recent decision in *Tembec Inc. v. The Queen*,[21] held that paragraph 20(1)(*f*) did not apply to the conversion of certain convertible debentures. The Tax Court of Canada came to this conclusion after referring to the *Imperial Oil* case and the decisions in *Teleglobe Canada Inc. v. The Queen*,[22] and *King Rentals Ltd. v. The Queen*.[23]

Question

Could the CRA provide its views in respect of the application of paragraph 20(1)(*f*) to exchangeable debentures, considering the decision of the Federal Court of Appeal in the *Tembec* case?

Response

The Supreme Court of Canada denied the leave application by Tembec Inc., so the decision is now firm and binding.

At the 2006 annual conference, reference was made to technical interpretations and rulings issued with respect to commodity-based loans and exchangeable debentures. We concluded that a deduction was available under subparagraph 20(1)(*f*)(ii) with respect to the increase in the amount payable on maturity of the commodity-based loan or on the exchange date of the debenture. At the time, we stated that the position taken in the above-noted technical interpretations and rulings would continue to be maintained for commodity-based loans and exchangeable debentures in place at that time. We added, however, that in light of the comments expressed in the Supreme Court's decision in the *Imperial Oil* case, the CRA would consult with its Legal Services staff to determine whether its positions are supportable at law. We also mentioned that if these consultations resulted in a change in the CRA's position, it would be announced to the public when the decision was made.

The CRA expects to complete its analysis of this issue by the fall of 2009. Should a change of position be necessary, it will be announced and administered on a prospective basis.

Convertible Debt

Subsection 214(7) applies to deem interest to be paid by a person resident in Canada to a non-resident person where a non-resident person assigns or otherwise transfers to a person resident in Canada a debt obligation issued by a person resident in Canada. The amount deemed to be interest is equal to the amount (the premium) by which the price for which the obligation is assigned or transferred (the assignment price) exceeds the price for which the obligation was issued. A redemption or cancellation of a debt obligation is deemed to be an assignment (pursuant to subsection 214(14)).

Subsection 214(7) does not apply to a debt obligation that is an "excluded obligation", as defined in subsection 214(8). An excluded obligation includes a debt obligation that was exempt from tax because of subparagraph 212(1)(*b*)(vii) as it applied to the 2007 taxation year.

Question 1

If a convertible debt obligation does not satisfy the requirements of subparagraph 212(1)(*b*)(vii) as it applied to the 2007 taxation year, can it qualify as an excluded obligation, pursuant to paragraph 214(8)(*c*), if the fair market value of the shares issued on conversion exceeds the issue price of the convertible debt obligation?

Response 1

In order to be an "excluded obligation" under paragraph 214(8)(*c*), a debt must

1) not be an indexed debt obligation;
2) have been issued for an amount that is not less than 97% of its principal amount; and
3) have a yield, expressed in terms of an annual rate on its issue price, that does not exceed 4/3 of the interest stipulated to be payable on its principal amount, or the amount outstanding as or on account of its principal amount.

Whether a particular debt meets these conditions is a question of fact, which must be determined according to the terms of a particular debt obligation. The sole fact that the fair market value of the shares issued on conversion exceeds the issue price of the convertible debt obligation is not, *per se*, determinative, where the issuer must repay the obligation for an amount equal to the issue price.

Question 2

If a convertible debt obligation does not qualify as an excluded obligation, what is the CRA's position as to the assignment price when the obligation is converted (into a fixed number of shares determined at the time the obligation arises)? Is it the fair market value of the shares issued or the amount added to stated capital on the conversion?

Response 2

We have accepted that the issuance of shares of a corporation can represent a payment of an obligation. In such a case, it is our view that the amount paid in satisfaction of the principal amount of the obligation depends on the agreement of the parties, which would generally be reflected by the stated capital of the shares issued.

Question 3

If subsection 214(7) applies to a convertible debt obligation, would the premium constitute "participating debt interest," as defined in subsection 212(3)?

Response 3

Participating debt interest is generally defined as interest, all or any portion of which is contingent or dependent on the use of or production from property in Canada or is computed by reference to revenue, profit, cash flow, commodity price or any similar criterion. The CRA invites submissions from the practitioner community to develop guidance on this issue.

Question 4

Assuming that subsection 214(7) applies to a convertible debt obligation and the resulting premium constitutes participating debt interest, would the CRA also consider non-participating interest paid pursuant to the terms of the obligation to also be participating debt interest solely because of the premium?

Response 4

Our initial analysis suggests that if the particular premium constitutes participating debt interest, the entire interest amount will be participating debt interest. However, to fully develop its position on this issue, the CRA invites submissions from the practitioner community.

Transfer Pricing and Dispute Resolution

On a similar front but more directly related to the relief of double taxation, there were many recommendations for tax administrations in the *Manual on Effective Mutual Agreement Procedures*, published by the OECD.[24] The CRA was very proactive in participating in the development in these recommendations and best practices and, back in 2005, was considering policies to address some key issues. Since then, there has been little guidance or publications on some of these initiatives (see collections, waivers, accelerated competent authority procedure [ACAP], interest relief).

Question

What initiatives has the CRA adopted, or will it adopt, in respect of these best practices to enhance timeliness and certainty, and overall improve the mutual agreement procedure (MAP) process in Canada?

Response

CRA is committed to taking appropriate actions to ensure that the competent authority process is accessible to all taxpayers and that requests for competent authority assistance are resolved on a timely basis. Such actions are predicated, however, on provisions of a specific income tax convention and the general framework of Canadian tax policy. In addition, some of these measures can be implemented only through a bilateral agreement between Canada and its tax treaty partner, such as establishing a predetermined timeline for completion of a MAP request.

The CRA actively participated in the OECD initiative on improving mechanisms for the resolution of tax treaty disputes to gather and exchange ideas with other OECD country members to improve the MAP process.[25] One result of this project was the OECD's *Manual on Effective Mutual Agreement Procedures* (MEMAP) in February 2007. The MEMAP outlined 25 "best practices" describing what was generally thought to be the most appropriate manner to deal with a MAP process or procedural issue; best practices are the practices generally followed by most OECD countries. MEMAP also included the following statement:

> "Although taxpayers and tax administrations should ideally strive towards implementing these best practices, it is recognized that there may be situations where their application may not be appropriate."[26]

From the CRA's viewpoint, the 25 "best practices" listed in the MEMAP can be loosely divided into three categories:

1) those solely related to the MAP process;
2) those having impacts on CRA programs other than the MAP; and
3) those more involved with Canadian tax policy than with procedure or process.

With respect to the first category, many of the best practices outlined in the MEMAP have been implemented as indicated in Information Circular IC71-17R5.[27] Best practice no 3, *Principled Approach to Resolution of Cases*, is found in paragraph 7 of IC71-17R5; the MAP report (an annual publication of the CRA since 2001-04)[28] and IC71-17R5 are elements of the best practice no 4, *Transparency and simplicity of procedures for accessing and using the MAP.*

Other initiatives, such as suspension of collections activity, extending the period to file waivers, interest relief, and ACAP, are issues related to other CRA programs and/or Canadian tax policy. The CRA has actively conducted internal consultations and made recommendations to the Department of Finance on these issues to ensure that all taxpayers are treated fairly in accordance with the Canadian tax system. For example, mandatory arbitration in the 5th protocol to the Canada US income tax convention[29] will enhance certainty in the MAP process by eliminating most double taxation on transactions between treaty residents of Canada and the United States.

Stock Benefit Withholding Requirements

Question

What is the CRA's view with respect to an employer's obligations to withhold from the cash proceeds when an employee exercises a stock option and sells the underlying shares on the same day?

Response

Legislatively, withholding of Canada Pension Plan (CPP) contributions and income tax is required on the full taxable benefit arising out of the exercise of a security option agreement. An employer is not required to withhold on a stock option benefit only when the employee is eligible and elects to defer including the benefit in income under subsection 7(8) of the Act.

In situations where the employer is aware that the employee wishes to exercise a security option and dispose of the security on the same day, the employer should withhold the full amount of CPP and income tax on the benefit. Where the employer is not aware of the employee's intention to sell the security on the same day, the employer can spread the withholding over

several pay periods if the amount to be withheld is larger than the employee's remuneration for the pay period.

When calculating the amount subject to deductions, the CRA will allow the employer to reduce the amount of the benefit by the deductions available under paragraph 110(1)(*d*), (*d*.1) or (*d*.01) of the Act, whichever applies.

Loss Consolidation and Provincial GAAR

At the Canadian Tax Foundation 2006 annual conference, the CRA commented that it recognizes that, in some instances, loss-consolidation transactions can have the effect of shifting income and losses between provinces with a resulting increase or decrease in provincial tax revenue. The CRA has also stated that loss-consolidation transactions between related parties are not subject to the general anti-avoidance rule (GAAR) and has issued numerous advance tax rulings in this regard. Historically, Ontario has not had a tax collection agreement with the CRA and has not given any Ontario provincial advance tax rulings regarding Ontario GAAR and loss utilization transactions.

Question

How does the CRA plan to address provincial GAAR issues with respect to loss-consolidation ruling requests that significantly shift income among provinces?

Response

Before issuing a ruling, CRA Rulings will recommend that practitioners obtain comfort from provincial tax authorities to minimize the risk of double taxation.

Provincial Income Allocation – Section 400 of the *Income Tax Regulations*

The following questions about provincial income allocation have been addressed and agreed upon by all members of the Allocation Review Committee (ARC), previously known as the Tri-Party Review Allocation Committee (TRAC). The ARC members are the tax administrations of Alberta, Québec and Ontario, and the CRA on behalf of the provinces with which the CRA has tax collection agreements.

Question 1 – Debentures

What is the approach of the ARC with regard to the exclusion of investment income in computing gross revenue in the application of subsection 402(5) of the *Income Tax Regulations* (the Regulations), and corresponding provincial legislation?

Response 1

Subsection 402(5) of the Regulations excludes interest on various financial instruments from the "gross revenue" component of the income allocation formula in subsection 402(3).

It is currently proposed by the ARC that a broad interpretation of the amounts excluded is appropriate for the purposes of subsection 402(5) of the Regulations.

This broad interpretation would include interest on promissory and other notes, bankers' acceptances, inter-company loans, certificates, GICs, unsecured debt instruments and other similar obligations, with the exception of interest on trade receivables and bank interest.

The ARC members will be looking to make their own announcement in 2009.

Question 2 – Substantial Machinery or Equipment

What is the ARC's current position on how long the substantial machinery or equipment must be used in a province or jurisdiction in order to deem a corporation to have a permanent establishment (PE) in that province or jurisdiction? Specifically, has the ARC developed any guidelines to qualify the phrase "at any time in a taxation year" as stated in paragraph 400(2)(*e*) of the Regulations?

Response 2

Generally, where a corporation **uses** (rented or owned) substantial machinery or equipment in a province or jurisdiction:

1) after 30 continuous days, on a particular site or project; or
2) after 90 days cumulative in a 12-month period;

the corporation is deemed to have a PE in that province or jurisdiction.

The 30-day test applies to each contract or project. The 90-day test applies to all contracts and projects in the province or jurisdiction in a 12-month period. Each is a stand-alone test, and both can result in a deemed PE of the corporation. Where the 12-month period straddles two taxation years, the corporation will be deemed to have a PE in the province or jurisdiction in the second taxation year, after 30 continuous days or 90 days cumulative.

Question 3 – Allocation of Leasing Revenue

What is the ARC's position on how leasing revenue with respect to non-financial leases should be allocated for all provinces and jurisdictions in order to avoid double taxation?

Response 3

Leasing revenue should be allocated as follows:

- Revenue should be allocated to the PE in the jurisdiction in which the lease property is being employed, if the taxpayer has reasonable knowledge of such information.
- If the taxpayer does not have reasonable knowledge of where the property is being employed, or if the taxpayer does not have a PE in the province or jurisdiction described above, the revenue should then be allocated to the PE to which the person negotiating the lease may reasonably be regarded as being attached.

Deductibility of Interest on Money Borrowed to Acquire Common Shares

The CRA has a longstanding administrative position of allowing taxpayers to claim a deduction for interest paid on money borrowed to purchase common shares of a corporation where the corporation has either

(a) no stated dividend policy or

(b) a dividend policy of paying dividends

when operational circumstances permit, on the basis that the purpose test in paragraph 20(1)(*c*) is met. The CRA's position traditionally has also been that if a corporation has asserted that it does not pay dividends or that dividends are not expected to be paid in the foreseeable future, the purpose test in paragraph 20(1)(*c*) is not met.[30]

Question

Will the CRA confirm that it continues to adopt the position on this issue that it has traditionally held, as described above, that is, that it is not necessary for the borrower to be able to point to a history of actual dividend payments by the corporation or to a policy that it will pay dividends in order to be entitled to deduct all interest on the borrowed money?

Response

In *Ludco Enterprises Ltd. v. Canada*,[31] the Supreme Court of Canada noted that the requisite purpose test for interest deductibility is whether, considering all of the circumstances, the taxpayer had a reasonable expectation of income at the time that the investment was made and that absent a sham, window dressing or other vitiating circumstances, a taxpayer's ancillary purpose may be nonetheless a *bona fide* objective of his or her investment, equally capable of providing the requisite purpose for interest deductibility.

The CRA's general views regarding interest deductibility are contained in the Interpretation Bulletin IT-533.[32] Specifically, it continues to be our view that:

> "Where an investment (e.g., interest-bearing instrument or preferred shares) carries a stated interest or dividend rate, the purpose of earning income test will be met "absent a sham or window dressing or similar vitiating circumstances" (*Ludco*). Further, assuming all of the other requisite tests are met, interest will neither be denied in full nor restricted to the amount of income from the investment where the income does not exceed the interest expense, given the meaning of the term income as discussed in ¶ 10.
>
> Where an investment does not carry a stated interest or dividend rate such as some common shares, the determination of the reasonable expectation of income at the time the investment is made is less clear. Normally, however, the CRA considers interest costs in respect of funds borrowed to purchase common shares to be deductible on the basis that there is a reasonable expectation, at the time the shares are acquired, that the common shareholder will receive dividends. Nonetheless, each situation must be dealt with on the basis of the particular facts involved."[33]

With respect to determining whether a common share investor has a reasonable expectation of income at the time the investment is made, in our view, it is not essential that dividends be received. This is merely one of many facts that would be considered. The dividend policy, if any, of the invested-in corporation would be another of the facts considered in such a determination, as well as evidence, if any, from corporate officials indicating whether dividends are expected to be paid, or whether shareholders are required to sell their shares in order to realize their value.

Each situation involving the investment of borrowed money in common shares must be dealt with on the basis of the particular facts involved, and the requisite test to be met for interest deductibility is whether the taxpayer had a reasonable expectation of income at the time the investment was made. The requisite test will not be met in all situations. Where the taxpayer, based on a review of the particular facts, did not have a reasonable

expectation of income at the time the investment in common shares was made, the requirements of paragraph 20(1)(*c*) of the Act will not be met.

For instance, consider the situation of a foreign grandparent and parent with a wholly-owned Canco, which itself has a foreign subsidiary that has not paid dividends since its acquisition years earlier. Assume that Canco borrows funds, at interest, from its foreign parent and uses the funds to acquire additional shares in its foreign subsidiary, which immediately on-loans the proceeds to the foreign grandparent at 0% interest. In this situation, because the foreign subsidiary will not use the proceeds in its business to generate income, combined with the fact that it has a history of not paying dividends, in our view, Canco does not have a reasonable expectation of income at the time the additional shares of the foreign subsidiary were acquired, and therefore the requirements of paragraph 20(1)(*c*) of the Act are not met.

5th Protocol to the Canada-US Tax Convention – Hybrid Entities

Assume that 100% of the voting stock of a US limited liability corporation (LLC) is owned by US qualifying persons, namely, 30% by a US-resident individual, 30% by a US-resident tax-exempt entity, and 40% by a US-resident corporation (USco). Assume also that the LLC is treated as a partnership for US tax purposes and that the LLC owns all of the shares of a corporation resident in Canada (Canco).

Question

What is the Canadian withholding tax applicable to dividends paid by Canco to the LLC on or after February 1, 2009?

Response

In responding to this question, we have assumed that each of the shareholders of the LLC will be considered, under the taxation laws of the US, to have derived the dividends through the LLC and that, by reason of the LLC being treated as fiscally transparent under the taxation laws of the US, the treatment of the dividends is the same as it would be if the dividends had been derived directly by each of the shareholders. We have also assumed that the tax-exempt entity is a trust, company, organization or other arrangement described in either subparagraph XXIX A(2)(*h*) or (*i*) of the treaty, the entity deals at arm's length with Canco, and the entity is exempt from tax on dividends derived from Canada by either paragraph XXI(2) or (3) of the treaty.

Paragraph IV(6) of the treaty provides as follows:

> "An amount of income, profit or gain shall be considered to be derived by a person who is a resident of a Contracting State where:
>
> (*a*) the person is considered under the taxation law of that State to have derived the amount through an entity (other than an entity that is a resident of the other Contracting State); and
>
> (*b*) by reason of the entity being treated as fiscally transparent under the laws of the first-mentioned State, the treatment of the amount under the taxation law of that State is the same as its treatment would be if that amount had been derived directly by that person."

In the circumstances described above, paragraph IV(6) would apply such that, for the purposes of the treaty, the dividends paid to the LLC by Canco will be considered to be derived by the shareholders of the LLC.

With respect to determining the appropriate withholding rate on the dividends derived by the US-resident individual and USco, paragraph X(1) and (2) of the treaty are relevant. These paragraphs provide as follows:

> "1. Dividends paid by a company which is a resident of a Contracting State to a resident of the other Contracting State may be taxed in that other State.
>
> 2. However, such dividends may also be taxed in the Contracting State of which the company paying the dividends is a resident and according to the laws of that State; but if a resident of the other Contracting State is the beneficial owner of such dividends, the tax so charged shall not exceed:
>
> (*a*) 5 percent of the gross amount of the dividends if the beneficial owner is a company which owns at least 10 percent of the voting stock of the company paying the dividends (for this purpose, a company that is a resident of a Contracting State shall be considered to own the voting stock owned by an entity that is considered fiscally transparent under the laws of that State and that is not a resident of the Contracting State of which the company paying the dividends is a resident, in proportion to the company's ownership interest in that entity); and

(*b*) 15 percent of the gross amount of the dividends in all other cases.

This paragraph shall not affect the taxation of the company in respect of the profits out of which the dividends are paid."

Applying paragraph IV(6) in conjunction with articles X and XXI of the treaty:

- 40% of the gross amount of the dividends paid by Canco to the LLC (the amount considered to have been derived by USco) will be subject to a 5% Canadian withholding tax.
- 30% of the gross amount of the dividends paid by Canco to the LLC (the amount considered to have been derived by the individual) will be subject to a 15% Canadian withholding tax.
- 30% of the gross amount of the dividends paid by Canco to the LLC (the amount considered to have been derived by the tax-exempt entity) will be exempt from Canadian withholding tax.

5th Protocol to the Canada-US Tax Convention – Limitation on Benefits

Question 1

Does the CRA agree that, in applying subparagraph XXIX A(2)(*e*) of the treaty, indirect ownership is not tested through a publicly traded company that is a qualifying person (that is, a company described in subparagraph XXIX A(2)(*c*))?

Response 1

In applying the indirect ownership test in subparagraph XXIX A(2)(*e*), the CRA will not look through to the ownership of the shares in a publicly traded company. In this respect, the CRA will be guided by the following comments to article XXIX A in the technical explanation to the fifth protocol:

"It is understood by the Contracting States that in determining whether a company satisfies the ownership test described in subparagraph 2(*e*)(i), a company, 50 percent or more of the aggregate vote and value of the shares of which and 50 percent or more of the vote and value of each disproportionate class of shares (in neither case including debt substitute shares) of which is owned, directly or indirectly, by a company described in subparagraph 2(*c*) will satisfy the ownership test of subparagraph 2(*e*)(i). In such case, no further analysis of the ownership of the company described in subparagraph 2(c) is required."[34] (underlining added)

Question 2

Would a tested company be regarded as a qualifying person pursuant to subparagraph XXIX A(2)(*e*) if 50% of its relevant shares are owned directly by a qualifying person described in subparagraph XXIX A2(*c*) and the other 50% of its relevant shares are owned directly by an individual who is not resident in the United States?

Response 2

A tested company would be regarded as a qualifying person if 50% of its relevant shares are owned directly by a qualifying person described in subparagraph XXIX A2(*c*). Our views in this respect are consistent with the comments to article XXIX A in the technical explanation to the fifth protocol cited in the response to the preceding question.

Question 3

In applying clause XXIX A(2)(*e*)(i) of the treaty, will the CRA take into consideration both the direct and indirect relevant shareholdings in a tested company to determine whether 50% or more of the relevant shares of the tested company are not owned, directly or indirectly, by persons other than qualifying persons?

Response 3

Yes.

Question 4

In applying the "active trade or business" test in paragraph XXIX A(3) of the treaty, will the CRA consider dividends received by a US resident on the shares of the capital stock of a Canadian-resident corporation and capital gains realized by a US resident from the disposition of the shares of a Canadian-resident corporation to be "income" that may, depending on the circumstances, be derived "in connection with" a relevant US trade or business?

Response 4

Paragraph XXIX A(3) extends the benefits of the treaty to a resident of a contracting state (other than a qualifying person) with respect to items of income derived from the other state in connection with, or incidental to, the active conduct of a trade or business (other than certain investment businesses) in the resident state. This paragraph applies to income derived directly or indirectly by a resident of a contracting state through

one or more persons who are resident in the other contracting state. However, paragraph XXIX A(3) does not apply to income derived in connection with a trade or business in the resident state unless that trade or business is substantial in relation to the activity carried on in the other state.

Meaning of "income"

The term "income" is not defined in the treaty. Paragraph III(2) of the treaty provides that where a term is not defined in the treaty, the term shall, unless the context otherwise requires, have the meaning it has under the law of the state concerning the taxes to which the treaty applies. In addition, paragraph 1 of annex B to the treaty states:

> "*1. Meaning of undefined terms*
>
> For purposes of paragraph 2 of Article III (General Definitions) of the Convention, it is understood that, as regards the application at any time of the Convention, and any protocols thereto by a Contracting State, any term not defined therein shall, unless the context otherwise requires or the competent authorities otherwise agree to a common meaning pursuant to Article XXVI (Mutual Agreement Procedure), have the meaning which it has at that time under the law of that State for the purposes of the taxes to which the Convention, and any protocols thereto apply, any meaning under the applicable tax laws of that State prevailing over a meaning given to the term under other laws of that State."

In our view, the context of paragraph XXIX A(3) does not require the term "income" to have a narrower meaning than it has under the *Income Tax Act*. Accordingly, both dividends and taxable capital gains would be considered to be income within the meaning of paragraph XXIX A(3).

Meaning of "in connection with"

In determining whether Canadian-source income has been derived by a US resident in connection with an active trade or business in the United States, the CRA will be guided by the commentary set out in the technical explanation to the fifth protocol and the 2006 US model technical explanation.[35]

In general terms, we would consider Canadian-source income to be derived "in connection with" a trade or business in the United States if the income is derived from an activity in Canada that is a part of, or is complementary to, the trade or business in the United States.

An activity in Canada will be considered to be *part of* a trade or business in the United States if the trade or business in the United States is upstream, downstream or parallel to the activity in Canada. Business activities will generally be considered to be upstream, downstream or parallel to each other if they relate to the production of the same types of products or the provision of the same or similar services. Business activities will generally be considered to be *complementary* if they are part of the same industry and the activities are interdependent (that is, success or failure of one activity will tend to result in success or failure of the other).

Example

The following example is intended to illustrate a situation in which Canadian-source dividends and taxable capital gains would be considered to be derived in connection with an active trade or business carried on in the United States by a US-resident corporation (USco).

Assume that USco carries on an active business in the United States (other than an investment business). USco owns all of the shares of Canco, a corporation resident in Canada, which carries on an active business in Canada that is parallel to USco's active business. The active business carried on by USco in the United States is substantial in relation to the active business carried on by Canco.

1) Canco distributes a portion of its after-tax income from its active business to USco in the form of dividends on its shares.

Since USco and Canco carry on parallel business activities and the dividends are paid out of the after-tax earnings from Canco's business, we would consider the dividends received by USco to be derived in connection with USco's active business.

2) USco sells the shares of Canco and realizes a taxable capital gain.

Since the value of the Canco shares (and thus the taxable capital gain) is derived from an active business in Canada that is parallel to the active business carried on by USco in the United States, we would consider the taxable capital gain on the disposition of the shares of Canco to be derived in connection with USco's active business.

Question 5

In the context of a competent authority determination made under paragraph XXIX A(6), does the CRA agreethat such a determination can be made in advance of any adverse determination having been made that the tested company is not otherwise a qualifying person or entitled to the relevant treaty benefits?

Response 5

Yes.

Functional Currency Tax Reporting Rules

Question 1

What is the meaning of "debt obligation" as the term is used in new section 261 of the Act? Does it include trade payables as well as inter-company loans and advances? If so, where a taxpayer has both a payable and receivable to and from the same entity, can these amounts be netted for purposes of computing the pre-transition debts of the taxpayer to which new subsections 261(8) to (10) of the Act apply?

Response 1

A debt obligation of a taxpayer means any indebtedness owing by the taxpayer, including trade payables, inter-company loans, and advances. In this respect, subsection 248(26) of the Act clarifies that an amount that a debtor becomes liable to pay (other than interest) as consideration for any property acquired by, or services rendered to, the debtor shall, for the purposes of applying the provisions of the Act, be considered to be an obligation issued by the debtor equal to the amount of the liability. There is no provision in new section 261 of the Act for netting amounts payable and receivable.

Question 2

Where a taxpayer has elected into the functional currency tax-reporting regime, will a reassessment of a prior Canadian currency year of the taxpayer be issued in Canadian dollars or the taxpayer's elected functional currency?

Response 2

The election, by a taxpayer, to become a functional currency tax reporter will not have an impact on the basis for assessment of any prior taxation year that is a Canadian currency year of the taxpayer. Therefore, if the CRA issues a reassessment in respect of a prior Canadian currency year of the taxpayer, the reassessment will show any adjustments in Canadian currency.

Similarly, if the taxpayer incurs a non-capital loss in a functional currency year and the taxpayer wishes to carry back that loss to offset taxable income in a Canadian currency year, the amount of the loss is converted to Canadian currency in the manner provided for in new subsection 261(15) of the Act. This converted amount is applied against the taxable income of the taxpayer in the Canadian currency year.

[1] *Income Tax Act*, RSC 1985, c.1 ((5th Supp.), as amended (herein referred to as "the Act").

[2] For example, subsection 50(1) of the *Canada Business Corporations Act*, RSC 1985, c. C-44, as amended.

[3] For example, ibid., at subsection 51(1).

[4] Please, consult our guidelines at the following address: http://www.cra-arc.gc.ca/whtsnw/tms/lgbl-eng.html

[5] See CRA document no. 2008-0284951C6, October 10, 2008.

[6] See also, supra note 4.

[7] 2008 DTC 4107 (TCC).

[8] IT-73R6, *The Small Business Deduction*, March 25, 2002.

[9] 2007 DTC 307 (TCC).

[10] 2002 DTC 6969 (SCC).

[11] 81 DTC 887, at 888 (TRB) and adopted by Collier J. in *Balanko v. MNR*, 88 DTC 6228, at 6230 (FCTD).

[12] Comments of Jessel MR in Smith v. Anderson (1880) 15 Ch. D. 247, at 258 (CA).

[13] *Leblanc*, supra note 9 at paragraph 28.

[14] 97 DTC 1416 (TCC).

[15] Sub nom. *Jevremovic et al. v. The Queen*, 2008 DTC 6263 (FCA).

[16] *Maege et all. v. The Queen*, 2006 DTC 3193, at paragraphs 31-38 (TCC).

[17] 2007 DTC 5199 (FCA).

[18] Canadian Accounting Standards Board, *Canadian Accounting Standards Board Confirms Changeover Date to IFRS*, Media Release, February 13, 2008.

[19] 98 DTC 6100 (SCC).

[20] *Imperial Oil Ltd. v. Canada; Inco Ltd. v. Canada*, 2006 DTC 6639 (SCC).

[21] 2008 DTC 3232 (TCC); aff's. (sub nom. *Provigo Inc. v. Canada)* 2008 CAF 205 (FCA).

[22] 2002 DTC 7517 (FCA).

[23] [1995] 2 CTC 2612, 96 DTC 1132 (TCC).

[24] Organisation for Economic Co-operation and Development, *Manual on Effective Mutual Agreement Procedures (MEMAP)* (Paris: OECD, February 2007).

[25] See Organisation for Economic Co-operation and Development, *Proposals for Improving Mechanisms for the Resolution of Tax Treaty Disputes: Public Discussion Draft* (Paris: OECD, February 2006)

[26] Supra note 24, at 5.

[27] IC71-17R5, *Guidance on Competent Authority Assistance under Canada's Tax Conventions*, January 1, 2005.

[28] Canada Revenue Agency, *Mutual Agreement Procedure Program Report: April 1, 2007-March 31, 2008* (Ottawa: CRA, 2008).

[29] *The Convention Between Canada and the United States of America with Respect to Taxes on Income and on Capital*, signed at Washington, DC, on September 26, 1980, as amended by the protocols signed on June 14, 1983, March 28, 1984, March 17, 1995, July 29, 1997, and September 21, 2007 (herein referred to as "the treaty").

[30] These traditional CRA's positions have been set out in CRA's documents 2003-0181585 (February 13, 2003), 2003-0012425 (May 26, 2003), 2003-0018115 (May 26, 2003) and 2001-0084055 (October 9, 2002).

[31] 2001 SCC 62.

[32] IT-533, *Interest Deductibility and Related Issues*, October 31, 2003.

[33] Ibid., at paragraph 31.

[34] United States, Department of the Treasury, *Technical Explanation of the Protocol*, done at Chelsea on September 21, 2007, amending the *Convention Between the United States of America and Canada with Respect to Taxes on Income and on Capital*, done at Washington on September 26, 1980, as amended by the Protocols done on June 14, 1983, March 28, 1984, March 17, 1995, and July 29, 1997, released by the Department of the Treasury on July 10, 2008.

[35] United States, Department of the Treasury, *United States Model Technical Explanation Accompanying the United States Model Income Tax Convention*, November 15, 2006.